No. 14903

United States Court of Appeals

for the Ninth Circuit

THE BANK OF ARIZONA, a Corporation,

Appellant,

vs.

NATIONAL SURETY CORPORATION, a Corporation,

Appellee.

BRIEF OF APPELLEE

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Appeal from the United States District Court for the District of Arizona

INDEX

Page

PRELIMINARY STATEMENT 1

SUMMARY OF ARGUMENT 1

ARGUMENT 3

I. Surety's Rights To Contract Proceeds by Subrogation Are Superior To Rights of Bank..... 3

Surety Subrogated To Government's Right..... 3

Right of Subrogation Relates Back 4

Bank Received Proceeds With Notice..... 5

II. Surety May Recover Contract Proceeds From Bank, A Subsequent Assignee With Notice From Bank.... 6

Surety's Assignment Valid 7

Actual Notice Not Required 9

III. Bank Holds Contract Proceeds As Constructive Trustee For Benefit Of Surety 12

CONCLUSION 15

TABLE OF CASES AND AUTHORITIES

CASES

	Page
California Bank v. United States Fidelity & Guar. Co. (C.C.A.9), 129 Fed.(2d) 751	3, 4, 5, 8
Collins v. O'Connell (C.C.A.9), 136 Fed.(2d) 141	9
Davis v. Kleindienst, 64 Ariz. 251, 169 Pac.(2d) 78	10
Haverstick v. Sheirich (Pa.), 155 Atl. 859, 76 A.L.R. 912	6, 11
Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404, 28 S.Ct. 389, 52 L.Ed. 547	3, 4
Hillman v. Busselle, 66 Ariz. 139, 185, Pac.(2d) 311	10
Labbe v. Bernard (Mass.), 82 N.E. 688	5, 13
Luke v. Smith, 13 Ariz. 155, 108 Pac. 494, (Aff'd. 227 U.S. 379, 33 S.Ct. 356, 57 L.Ed. 558)	10
Maricopa Utilities Co. v. Cline, 60 Ariz. 209, 134 Pac. (2d) 156	10
Martin v. National Surety Co., 300 U.S. 588, 57 S.Ct. 531, 81 L.Ed. 822	8
Morley Construction Co. v. Maryland Casualty Co., 300 U.S. 185, 57 S.Ct. 325, 81 L.Ed. 593	6
National Surety Co. v. Pixton (Utah), 208 Pac. 878, 24 A.L.R. 1487	3
National Surety Corporation v. United States (Ct.Cl.), 133 Fed. Supp. 381	6, 11

Page

Pacific Indemnity Co. v. Grand Ave. State Bank of Dallas (C.A.5), 223 Fed.(2d) 513 ..... 9, 12, 13

Royal Indemnity Co. v. United States (Ct.Cl.), 93 Fed. Supp. 891 ..... 6, 8, 11

STATUTES

31 U.S.C.A., § 203 8

41 U.S.C.A., § 15 8

TEXTS

3 Am. Jur., Appeal and Error, Sec. 954, p. 516 7

Restatement in the Courts, Permanent Edition, p. 82 10

Restatement of Agency, Sec. 9(1) 9

Restatement of Contracts, Sec. 166, 173, 174 9

Restatement of Restitution, Sec. 168, 174a 9, 13

Restatement of Torts, Sec. 757 9

Restatement of Trusts, Sec. 297 9

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BRIEF OF APPELLEE

PRELIMINARY STATEMENT

For convenience and brevity we will refer to the parties as follows: Appellee National Surety Corporation as "Surety"; Appellant The Bank of Arizona as "Bank" and Dollar Construction Company as "Contractor". Contract No. DA-02-002-AVI-104, executed by the Government and the Contractor, will be referred to as "the Contract"; and the work provided for therein will be referred to as the "Navajo job". Persons who supplied labor and materials in the prosecution of the work provided for in the Contract will be referred to as "the Materialmen". The Transcript of Record will be referred to as "Tr."

SUMMARY OF ARGUMENT

The Government had not only a right but an equitable obligation to see that the Materialmen were paid. When Bank, pur-

suant to an assignment by Contractor, received the Contract proceeds on December 15, 1952, it had constructive notice that they were part of a fund in which Surety had, or might thereafter acquire, a superior right. Surety became subrogated to the right of the Government, and its right of subrogation related back to the date of the payment bond, June 18, 1952.

As a condition precedent to and as part of the consideration for the execution of the payment bond by Surety, Contractor assigned to Surety all moneys that might be due and payable at the time of any breach or default in the Contract. This assignment was valid as to a subsequent assignee of the Contractor. The Contract, as well as the Miller Act, expressly required Contractor to furnish a payment bond conditioned that Contractor should promptly make payment to the Materialmen. Both at the time Contractor assigned the Contract proceeds to Bank and at the time Bank received those proceeds from the Government, Contractor had failed promptly, or at all, to make payment to the Materialmen and was therefore in default. Surety's right to the proceeds of the Contract by virtue of its assignment existed prior to Bank's assignment and long prior to receipt by Bank of those proceeds. Bank admits that at the time it received the Contract proceeds it knew, or in the exercise of reasonable care and diligence should have known, that Contractor was in default. Bank received the Contract proceeds with constructive notice of Surety's assignment, and Surety may therefore recover those proceeds from Bank.

The loan was made by Bank to Contractor for the avowed purpose, in part at least, of enabling Contractor to pay the Materialmen. At the time of the loan, Bank knew that Contractor was having financial difficulty and could not pay the Materialmen except out of the proceeds of the Contract or the loan. Bank did not inquire as to how much was due the Materialmen or whether the loan proceeds were actually used to pay them. In fact, none of the loan proceeds were so used, but were diverted by the Contractor to some other purpose.

Bank knew Contractor had furnished a payment bond and should have known that the payment bond was conditioned that Contractor should promptly make payment to the Materialmen. At the time it received the Contract proceeds Bank knew or should have known Contractor was in default. Bank, therefore, now holds the Contract proceeds in constructive trust for the benefit of Surety.

For any one, or all, of the foregoing reasons the judgment of the trial court should be affirmed.

ARGUMENT

I

Surety's Rights to Contract Proceeds by Subrogation Are Superior to Rights of Bank

The payment bond executed by Surety was conditioned that Contractor should promptly make payment to all persons supplying labor and materials in the prosecution of the work provided in the Contract. (Tr. 50) The Navajo job was completed on October 20, 1952. (Tr. 51) At that time Contractor had failed promptly, or at all, to make payment to the Materialmen. (Tr. 51)

Surety Subrogated to Government's Right

The Government had not only a right but an equitable obligation to see that the Materialmen were paid; Surety became subrogated to that right. *Henningsen v. United States Fidelity & Guaranty Co.,* 208 U.S. 404, 28 S.Ct. 389, 52 L.Ed. 547; *California Bank v. United States Fidelity & Guar. Co.* (C.C.A. 9), 129 Fed.(2d) 751.

Bank argues that when it received the Contract proceeds the Government no longer had any right to which Surety could be subrogated. In support of this argument Bank relies on *National Surety Co. v. Pixton* (Utah), 208 Pac. 878, 24 A.L.R. 1487. In this case the court held that where a state statute compels the treasurer, upon deposit of state funds in a bank, to secure the re-

payment of those funds, the state waives its preferential right over other depositors, precluding the surety on the bond for repayment from acquiring that right of subrogation. It should be noted that the state's preferential right was held to be waived *before* the surety had executed the bond.

Right of Subrogation Relates Back

Here, Surety's right of subrogation relates back to the date of the payment bond, June 18, 1952, as to an assignee of Contractor who received the Contract proceeds with notice that they were part of a fund in which Surety had or might thereafter acquire a superior right. *Henningsen v. United States Fidelity & Guaranty Co.,* supra, 208 U.S. 404, 28 S.Ct. 389, 52 L.Ed. 547; *California Bank v. United States Fidelity & Guar. Co.* (C.C.A. 9), supra, 129 Fed.(2d) 751.

On October 20, 1952, Contractor borrowed $10,000.00 from Bank and executed an assignment to it of the proceeds of the Contract. (Tr. 51) At that time Bank knew the Navajo job had been completed and the proceeds of the Contract were shortly forthcoming. It knew that Contractor had not paid all the Materialmen. It knew that Contractor had been required to and had furnished a payment bond and should have known the payment bond was conditioned that Contractor should promptly make payment to the Materialmen. (Tr. 51, 52) It knew that Surety was obligated to pay the Materialmen if Contractor failed to do so. (Tr. 52)

Bank's vice-president who negotiated the loan to Contractor had no previous experience with assignments of the proceeds of Government contracts. (Tr. 72-73; 104-105; 157) He knew that Guaranty Title & Trust Company did some bond work for Bank and that Bank's president was connected with that company. (Tr. 73; 147) Yet he did not inquire of Bank's president, or anyone, as to the rights of Surety to the proceeds of the Contract. (Tr. 73; 156) Bank's president was well aware of those rights. (Tr. 174-175)

Bank Received Proceeds With Notice

The proceeds of the Contract were received by Bank from the Government on December 15, 1952. (Tr. 53) In paragraph III of its Complaint Surety alleges that as a condition precedent to and as part of the consideration for Surety's undertaking, Contractor assigned to Surety ". . . all moneys and properties that may be due and payable to the contractor at the time of any breach or default in said contract..." (Tr. 5-6) In paragraph IX of its Complaint Surety alleges as follows (Tr. 10):

> "At the time it received the aforesaid sum of $12,580.00 from the Government, the Bank knew, or in the exercise of reasonable diligence should have known, that said sum represented the amount due on the aforesaid contract and that the Contractor was in default in that he had failed promptly or at all to make payment to all persons who had supplied labor and material for the prosecution of the work provided for in the contract with the Government."

Paragraph IX of Bank's Answer *admits* the allegations of paragraph IX of the Complaint. (Tr. 17)

In *California Bank v. United States Fidelity & Guar. Co.* (C.C.A. 9), supra, 129 Fed. (2d) 751, 755, the court said:

> "* * * At the time it received the $12,114.34, appellant knew that Anderson had received it from the United States under the aforesaid contracts; but appellant had no notice or knowledge of Anderson's default until July 19, 1938—nineteen days after it received the $12,114.34. Thus appellant received the $12,114.34 without notice or knowledge that it was part of a fund in which appellee had, or might thereafter acquire, a superior right. We hold, therefore, that appellee is not entitled to recover any part of the $12,114.34 from appellant."

Here, Bank knew that Contractor was in default when it received the Contract proceeds. Thus it did have notice or knowledge that they were part of a fund in which Surety had, or might thereafter acquire, a superior right. See also *Labbe v. Bernard* (Mass.), 82 N.E. 688.

Bank cannot now be heard to say it was ignorant of Surety's rights. With knowledge of the facts outlined above, it was put upon inquiry as to those rights. *Haverstick v. Sheirich* (Pa.), 155 Atl. 859, 76 A.L.R. 912; *Royal Indemnity Co. v. United States* (Ct.Cl.), 93 Fed. Supp. 891; *National Surety Corporation v. United States* (Ct.Cl.), 133 Fed. Supp. 381.

II

Surety May Recover Contract Proceeds From Bank, A Subsequent Assignee With Notice

The judgment of the trial court and the theory upon which it was rendered are correct and should be affirmed. We respectfully submit however that the judgment should also have been rendered on the theory advanced by Surety in its proposed findings of fact numbered 10(j) and 12, and its proposed conclusions of law numbered I and II. (Tr. 23-25; 26) We do not attack the judgment or ask that it be altered or modified in any way. We do urge that there was an additional legal reason supporting the judgment which the trial court should have adopted. *Morley Construction Co. v. Maryland Casualty Co.,* 300 U.S. 185, 57 S.Ct. 325, 81 L.Ed. 593.

Surety's proposed conclusion of law No. I reads as follows (Tr. 26):

> "At the time Contractor assigned the proceeds of the Contract to Bank there existed a valid prior assignment of the contract proceeds by Contractor to Surety."

The trial court found that as a condition precedent to and as part of the consideration for the execution of the performance bond and the payment bond Contractor executed and delivered to Surety an application wherein Contractor assigned to Surety any and all moneys that might be due and payable to Contractor at the time of any breach or default in the Contract to indemnify Surety for any liability Surety might incur by reason of having executed the performance bond and the payment bond. (Tr. 50)

Defendant argues that Surety's application was for a perform-

ance bond, not a payment bond, that since the Contract was fully performed there was never any breach or default and that therefore, Surety never had any assignment. This argument does not perceive the true reasoning of the trial court in finding the fact above mentioned and refusing Surety's proposed conclusion of law No. I.

It is true the printed language of the form (Tr. 127-130) indicates that it is an application for a performance bond. Unfortunately the entire record is not before this Court. It should therefore be presumed that the evidence supported the trial court's finding.

3 *Am. Jur., Appal and Error,* Sec. 954, p. 516-518

It is apparent however, even from the record before this Court, that the application and its provisions were intended by Surety and Contractor to, and did in fact, apply to both the performance bond and the payment bond. The Contract price was in the original sum of $12,180. (Tr. 49) Both the Contract and the Miller Act (40 U.S.C.A. § 270a) required the Contractor to furnish a payment bond and a performance bond, each in the sum of one-half the Contract price. (Tr. 49-50) The "Contract Bond" referred to in the application was in the sum of $12,180.00; no other application was made. No bond was ever executed in the sum of $12,180.00. The performance bond and the payment bond executed by Surety were in the sum of $6,090.00 each. (Tr. 50)

Surety's Assignment Valid

While the Contract contained no express provision for payment of the Materialmen, it expressly required Contractor to furnish a payment bond which, pursuant to the Miller Act, was conditioned that Contractor should promptly make payment to the Materialmen. Thus the payment bond was very much a part of the Contract and when, on and prior to October 20, 1952 (the completion date), Contractor had failed promptly, or at all, to make payment to the Materialmen it was in default under the provisions of the Contract and the payment bond. The trial court

properly so concluded. (Tr. 53-54) As shown above, Bank admits that when it received the Contract proceeds on December 15, 1952 it knew, or in the exercise of reasonable diligence should have known, that Contractor was in default.

The trial court refused to conclude that Surety had a valid prior-existing assignment because Surety is not a bank, trust company or other financing institution and did not comply with the Assignment of Claims Act of 1940, 31 U.S.C.A. § 203, 41 U.S.C.A. § 15. We think the trial court was wrong in this regard.

It is true the Anti-Assignment Statute, 31 U.S.C.A. § 203, declares assignments of claims against the Government before their allowance to be "absolutely null and void". But this Statute is for the protection of the Government only. It is well settled that notwithstanding the provisions of the Anti-Assignment Satute, an assignment by a Contractor to his Surety of the proceeds of a Government contract is valid and enforceable as between the surety and a subsequent assignee of the contractor. *Martin v. National Surety Co.,* 300 U.S. 588, 57 S.Ct. 531, 81 L.Ed. 822; *California Bank v. United States Fidelity & Guar. Co.* (C.C.A. 9), supra, 129 Fed. (2d) 751.

The Assignment of Claims Act of 1940 merely lifted the bans set up by the Anti-Assignment Statute and authorized the Government to recognize an assignment to a bank, trust company or other financing institution where the contract proceeds exceed $1,000.00. It gave the classified assignees a new right against the Government; but it did not give them any new or greater rights as against a prior assignee, such as the Surety. *Royal Indemnity Co. v. United States* (Ct.Cl.), supra, 93 Fed. Supp. 891.

Consequently a surety to whom the contractor has assigned the proceeds of a Government contract may recover those proceeds from a subsequent assignee who receives them with notice of prior assignment. *Martin v. National Surety Co.,* supra, 300 U.S. 588, 57 S.Ct. 531, 81 L.Ed. 822; *California Bank v. United States Fidelity & Guar. Co.* (C.C.A. 9), supra, 129 Fed. (2d) 751;

Pacific Indemnity Co. v. Grand Ave. State Bank of Dallas (C.A. 5), 223 Fed. (2d) 513; *Restatement of Contracts,* Sec. 173.

Actual Notice Not Required

Bank relies upon the fact that it had no actual notice of Surety's assignment when it received the Contract proceeds. Actual notice is not required.

The Arizona Supreme Court has repeatedly held that in the absence of conflicting statutes or decisions it will follow the Restatement. *Collins v. O'Connell* (C.C.A. 9), 136 Fed. (2d) 141. The *Restatement of Contracts,* Sec. 174, provides that an assignee "for value in good faith without notice" is not subject to latent equities in favor of another; and the comment to this section refers to Sec. 166, Comment b. Comment b under Sec. 166, together with the first illustration thereof, reads as follows (page 210):

> "b. The promisee's right, moreover, is defeasible by a subsequent assignment to a bona fide purchaser for value without notice of the prior right, in this respect differing from a present assignment of a future right (see § 154). What is meant by 'value' and by 'notice' in the phrase bona fide purchaser for value without notice is not always identical in different kinds of transactions. The law regarding this is stated in the Restatement of Trusts. *Illustrations:*
>
> 1. A promises B, in consideration of a horse sold to him by B, that A will thereafter assign to him money which will fall due to A from C under an existing employment. A subsequently assigns for value the right to D, *who neither knows nor has reason to know of the previous promise.* B learns of this assignment and thereafter collects the money when due from C. B acquires no right against C or power to discharge C and therefore D can recover from B the money so collected or can get judgment against C." (emphasis supplied)

The *Restatement of Trusts,* Sec. 297, as well as the Restatement of Agency, Sec. 9(1), the *Restatement of Restitution,* Sec. 174a, and the *Restatement of Torts,* Sec. 757, all provide that a person has notice of a fact when he knows it, has reason to know it or should

know it. Nowhere in the Restatement is the term "notice" confined to mean actual notice. *Restatement in the Courts, Permanent Edition,* page 82.

As indicated by the Restatement, a subsequent assignee, in order to avoid the rights of others, must be a bona fide purchaser for value in good faith without notice. The Arizona Supreme Court in the early case of *Luke v. Smith,* 13 Ariz. 155, 108 Pac. 494, 496 (Aff'd. 227 U. S. 379, 33 S. Ct. 356, 57 L. Ed. 558) held:

> "* * * Where one has notice of a fact affecting property which he seeks to purchase, which puts him upon inquiry, he is chargeable with the knowledge which the inquiry, if made, would have revealed; and one is put upon inquiry by notice of a claim which is inconsistent with the title he seeks to obtain, and must exercise due diligence to ascertain the facts upon which the claim is based. In Fidelity Company v. Railroad Co., 32 W. Va. 244, 9 S. E. 180, it is said that: 'Whatever is sufficient to put a person on inquiry is considered as conveying notice; for the law imputes a personal knowledge of a fact, of which the exercise of common prudence might have apprised him. When a subsequent purchaser has actual notice that the property in question is incumbered or affected, he is charged constructively with notice of all the facts and instruments, to the knowledge of which he would have been led by inquiry into the incumbrance or other circumstances affecting the property of which he had notice.' "

The rule was reiterated in *Davis v. Kleindienst,* 64 Ariz. 251, 169 Pac. (2d) 78, 83 as follows:

> "* * * The law seems to be settled that a person who fails to exercise due diligence to avail himself of information which is within his reach is not a bona fide purchaser. University of Richmond v. Stone, 148 Va. 686, 139 S. E. 257. Thus a purchaser who has brought to his attention circumstances which should have put him on inquiry which if pursued with due diligence would have led to knowledge of an adverse interest in the property, is not a bona fide purchaser."

See also *Maricopa Utilities Co. v. Cline,* 60 Ariz. 209, 134 Pac. (2d) 156 and *Hillman v. Busselle,* 66 Ariz. 139, 185 Pac. (2d) 311.

In *Haverstick v. Sheirich* (Pa.), supra, 155 Atl. 859, 76 A.L.R. 912, the bank likewise contended it had no actual knowledge of the surety's rights. The court said (76 A.L.R. 915-916):

> "* * * The bank cannot rest upon the contention that it did not in fact know of these things; it was put upon inquiry regarding them, and, inquiry having become a duty, it was bound by all it would have ascertained that it duly inquired. It knew, for it was bound to know, that the statute, the contract, and the bond made the rights of the materialmen and workmen paramount to those of the contractor, and that upon these provisions the materialmen, workmen, and surety had the right to rely. Nothing that the bank could do could alter that status, and its rights rise no higher than those of the contractor. It is not disputed that the bank was affected with notice that there was a surety, which became liable to pay the materialmen and workmen if the contractor did not. This liability being statutory, and known by the bank to be so, *common prudence called upon it, before it made its loan, to inquire into the circumstances under which the surety assumed that liability.* * * *" (emphasis supplied)

Likewise in *Royal Indemnity Co. v. United States* (Ct. Cl.), supra, 93 Fed. Supp. 891, 894 the court held:

> "Payment and performance bonds are required by the Miller Act of all Government contractors. The bank is charged with knowledge of this law. It took its assignment and advanced its money after the contract had been entered into between the contractor and the United States. *It is apparent that the bank knew of the surety's interest in the transaction or was, at the very least, put upon notice as to the possibility of an equity possessed by the surety in the proceeds of the contract.* The contract between the contractor and the surety clearly created in the surety an equity in any proceeds of the contract. This equity could be dissolved only when the contractor had met all the obligations secured by the bonds." (Emphasis supplied)

This rule was reaffirmed in *National Surety Corporation v. United States* (Ct. Cl.), supra, 133 Fed. Supp. 381.

At the time it received the proceeds of the Contract Bank knew

that Contractor had furnished a payment bond and that Surety would have to pay the Materialmen if Contractor failed to do so; it knew that Contractor had failed promptly, or at all, to pay some of the Materialmen; admittedly, it knew, or in the exercise of reasonable diligence should have known, that Contractor was in default under the provisions of the Contract and the payment bond. Surety's rights to the proceeds of the Contract had matured through the Contractor's default prior to Bank's assignment and long prior to its receipt of those proceeds. Bank cannot now hide behind its lack of actual knowledge of Surety's assignment. It was put upon inquiry, and had it made the least inquiry of its own president or of Surety it would have learned of the assignment and Surety's rights. Bank is therefore charged with notice of Surety's assignment and its rights to the Contract proceeds. *Pacific Indemnity Co. v. Grand Ave. State Bank of Dallas* (C.A. 5), supra, 223 Fed.(2d) 513. For these reasons the trial court should have found in accordance with Surety's proposed findings of fact numbered 10(j) and 12, that at the time the assignment to it was executed and at the time it received the Contract proceeds Bank knew or in the exercise of reasonable care and diligence should have known that "Contractor had previously assigned the proceeds of the Government contract to Surety".

Also, for the foregoing reasons the trial court should have sustained Surety's proposed conclusion of law No. II as follows (Tr. 26):

> "The rights of Surety under the prior assignment are superior to the rights of Bank which procured the execution of the subsequent assignment and received the proceeds of the Contract with notice of the prior assignment and the rights of Surety."

III

Bank Holds Contract Proceeds as Constructive Trustee for Benefit of Surety

When Contractor applied for the loan it showed Bank a copy of the Contract and Bank inquired as to what the money was needed

for. Contractor replied. "To pay for materials and labor on this job, part of it I am just finishing up and I want to clear up all the bills on it." (Tr. 136) Thus the loan was made for the avowed purpose, in part at least, to pay the Materialmen. Bank knew Contractor was having financial difficulty and could not pay the Materialmen except out of the proceeds of the Contract or the proceeds of Bank's loan. (Tr. 51-52) Yet prior to receiving the Contract proceeds Bank made no inquiry to determine how much was due the Materialmen (Tr. 73) or whether Contractor had actually used the loan proceeds to pay them. (Tr. 74-75)

In fact none of the loan proceeds were used in payment of the Materialmen. (Tr. 53) They were diverted by the Contractor to some other purpose. At the time it received the Contract proceeds Bank knew that Contractor had furnished a payment bond and that the Surety thereon would have to pay the Materialmen if Contractor failed to do so. At that time Bank also knew, or in the exercise of reasonable care and diligence should have known, that Contractor was in default under the provisions of the Contract and the payment bond. This Bank admits.

Under the authorities above cited Bank cannot now be heard to say it had no actual notice of Surety's rights. With knowledge of the above facts it was bound to know Surety had some rights, and it was put upon inquiry to determine the nature and extent of those rights. Having failed to do so, it now holds the Contract proceeds in constructive trust for the benefit of Surety. *Labbe v. Bernard* (Mass.), supra, 82 N.E. 688; *Pacific Indemnity Co. v. Grand Ave. State Bank of Dallas* (C.A. 5,), supra, 223 Fed.(2d) 513; *Restatement of Restitution,* Sec. 168.

Bank has foreclosed itself on this point by the following admission on page 25 of its Brief:

> "* * * Knowing the source of the money, the creditor is bound to know that the Miller Act has required the Contractor to execute a Performance Bond, which bond must, according to law, provide for the protection of laborers and materialmen; the creditor is bound to know that if the laborers

> and materialmen are not paid the Surety must pay them; therefore the creditor must ascertain at his peril whether or not there are any outstanding obligations of the Contractor to the laborers and materialmen before accepting payment, else he assumes the obligations of the compensated Surety to the extent of the payment received."

A bank with knowledge of the facts that Bank knew when it received the Contract proceeds should not be permitted to thumb its nose at those facts and later shield itself behind the veil of ignorance. If that were condoned by the law the courts would pave the way for unscrupulous contractors to divert the proceeds of Government contracts from the persons equitably entitled thereto. For in every instance such contractors could borrow a sum equal to the contract proceeds from a bank, assign the proceeds to the bank and then abscond with or use the money borrowed for some purpose wholly unconnected with the contract. This would leave the surety to pay laborers and materialmen without any means of protection or exoneration whatsoever.

The trial court properly concluded (Tr. 54):

> "Contractor held its right to the proceeds of the Contract, subject to an equitable lien in favor of Surety; when it transferred its right to Bank, Bank took the proceeds of the Contract subject to Surety's equitable lien."

This conclusion is in accord with the spirit and the reasoning of the cases above cited.

CONCLUSION

Under any one, or all, of the authorities advanced above: subrogation, prior assignment and constructive trust, Surety's rights to the Contract proceeds are superior to those of Bank. The judgment of the lower court should therefore be affirmed.

Respectfully submitted,

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